**Southwestern Bell**

DOCKET FILE COPY ORIGINAL

*June 16, 1994*

**D. T. Hubbard**
Vice President
Revenues and
Public Affairs

*The Honorable Reed E. Hundt*
*Chairman*
*Federal Communications Commission*
*1919 M Street, N.W. Room 814*
*Washington, D.C. 20554*

**RECEIVED**

JUN 16 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

*Re: In the Matter of 1993 Annual Access Tariff Filings, Tariffs of Local Exchange Carriers, CC Docket No. 93-193*

*Dear Chairman Hundt:*

*As a follow-up to my June 1 meeting with you on the above referenced matter, I am herein providing a concise summary of the FAS 106/Other Post Employment Benefits (OPEB) issue.*

*The question of exogenous treatment for OPEBs, which represents real economic costs to the Price Cap regulated local exchange telephone companies, has been before the Commission for over four years. The record created by the Commission's June 23, 1993 Order to further investigate this matter has been complete for sometime, and strongly weighs in favor of exogenous recovery.*

*I would like to ask again that the Commission conclude its further investigation of this issue, and order that the interstate rates which currently include cost recovery for OPEBs be made permanent concurrent with the upcoming July 1, 1994 effective date for revised interstate access tariffs.*

*Thank you again for your consideration on this very important matter.*

*Sincerely,*

D. T. Hubbard

*Attachment*

*cc: Commissioner Ness*
*Commissioner Chong*
*Mr. William F. Caton*

One Bell Center
Suite 4106
St. Louis, MO 63101

Phone 314 235-7600

No. of Copies rec'd 0+2
List ABCDE

# Exogenous Cost Treatment of Incremental SFAS 106 Costs

## Defining SFAS 106

- Statement of Financial Accounting Standards No. 106 (SFAS 106) is the statement adopted by the Financial Accounting Standards Board (FASB) regarding Generally Accepted Accounting Practices (GAAP) change for Other Postretirement Employee Benefits (OPEBs).

- The Commission's Part 32 Accounting Rules require regulated telecommunications carriers to maintain their financial records in accordance with GAAP.

- OPEBs are benefits other than pensions paid on behalf of retirees. These benefits are primarily medical care, but also include dental care and life insurance.

- SFAS 106 moves from a cash basis to an accrual basis for recording the costs associated with postretirement benefits earned by employees.

- SFAS 106 requires that companies record the cost of these benefits as they are earned by employees, rather than waiting to reflect these costs after employees retire and benefits are received by retirees. Thus, SFAS 106 properly matches the cost of providing OPEBs with when they are earned.

# Description of SFAS 106 Accounting

**Example of a single individual** (based on typical characteristics):

- **Hired in 1974.**
- **Expected to be "vested" for OPEBs in 2000 at 50 years old with 25 years service.**
- **Expected to retire in 2010 with 36 years service.**
- **Expected to die in 2028 at age 78.**

| | Benefits Accrue | | | Benefits Paid | |
|---|---|---|---|---|---|
| Year | 1974 | 1993 | 2000 | 2011 | 2028 |
| Age of Employee | 24 | 43 | 50 | 61 | 78 |
| Length of Service | 0 | 18 | 25 | 36 | -- |

**TBO**

**Attribution Period**

**Total Expected Length of Service**

- **Benefits are accrued as earned by employee from the year 1974 through 2000 (the attribution period). Benefits are paid from the year 2011 through 2028.**
- **The TBO, Transition Benefit Obligation, is the portion of total SFAS 106 costs associated with benefits already earned at the point in time when SFAS 106 accounting is adopted, 1993 in this example. [The TBO is only about 70 percent (18 years divided by 25 years) of the present value of expected benefits.]**

## SFAS 106 expenses are real economic costs.

- **SFAS 106 recognizes that an employee earns OPEBs over the employee's service life and that the company should recognize its costs of providing OPEBs during the same period.**

- **On December 26, 1991, by order, the FCC adopted GAAP accounting for OPEBs for all regulated carriers. Thus, SFAS 106 costs are legitimate regulated costs of service, and have been recognized as such in Part 32 of the Commission's Rules.**

- **Rate of return regulated carriers have been allowed rate recovery of the incremental costs of SFAS 106.**

  - **It is a pure accident of timing that accrual accounting for OPEBs was mandated after price cap regulation. Price caps were debated for 4 years; accrual accounting for OPEBs was debated for over 12 years.**

- **During the debate over price cap regulation, both LECs and the Commission recognized that the long-pending accrual accounting for OPEBs was a primary (possibly the most significant) example of the need for the exogenous cost adjustment mechanism within the price cap framework.**

# The Exogenous Recovery of OPEBs.

**At the inception of price caps for AT&T and the LECs, exogenous recovery was defined exclusively by <u>lack of control over a mandated change in costs</u>. [1989-90]**

- **Includes the actions of legislatures, courts or commissions that imposed changes in costs -- examples: new laws, court-imposed regulatory obligations and separations rules changes.**
- **Under this definition the mandated change in accounting cost required by FASB and the Commission due to SFAS 106 is an exogenous event.**
- **The LECs <u>cannot control</u> whether SFAS 106 is adopted or what the incremental effect on costs will be.**

## <u>FCC Orders</u>

- The LEC Price Cap Order (at para. 168) stated:
  - **"Changes in LEC costs that are caused by changes in Part 32 of our Rules ... will be considered exogenous." Subsequently, the Commission adopted an order that accepted SFAS 106 accounting.**
  - **"No GAAP change can be given exogenous treatment until the Financial Accounting Standards Board has actually approved the change and it has become effective." The FASB approved the SFAS 106 accounting change and it became effective 1-1-93.**

- The AT&T Price Cap Order on Reconsideration (at para. 75) stated:
  - **"GAAP changes should be eligible for exogenous treatment after a case-by-case review indicates that the change will not be adequately reflected in the GNP-PI." Accordingly, no additional standard of <u>control</u> needed to be met. Rather, the requirement for recovery simply rest with a demonstration that OPEB costs are not in the GNP-PI. It is exactly this showing that the price cap LECs have made in their Direct Cases filed June 1, 1992 and Rebuttals filed July 31, 1992.**

- The LEC Price Cap Order on Recon. (at paras. 61 and 62) stated:
  - "Carriers that chose to accrue OPEB expenses were no more 'right' or 'wrong' than carriers that chose to await the GAAP Change." ... "Carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEBs are not necessarily foreclosed from recovering those costs." The price cap LECs request that rate recovery be allowed fairly for all price cap LECs.

- Thus, the Commission ultimately required two showings for the incremental SFAS 106 costs to be exogenous:
  - The FASB change was outside the control of the LEC, and;
  - The costs are not already recovered due to operation of the price cap formulas (i.e., not reflected in the GNP-PI inflation measure).

## Double-Counting in GNP-PI [1991]

- The price cap LECs introduced an unrebutted study prepared by Godwins which demonstrated the fact that the accounting change is not reflected in the GNP-PI.

- The Godwins study demonstrated that only 0.7% of the incremental SFAS 106 could be double counted in GNP-PI (inflation adjustment).

- Godwins showed that over 72% of U.S. employees work for companies that do not even pay OPEBs and therefore would not be in the GNP-PI.

- The Godwins study was extremely conservative in nature. Conservative in this sense means that all assumptions in the Godwins study were chosen so that they overestimated the extent that SFAS 106 costs are captured in the GNP-PI.

  The NERA approach, though different, is very tractable and reasonable. It yields similar results -- that the incremental costs of SFAS 106 are not recovered through changes in the GNP-PI.

- **Moreover, SWBT reduced its exogenous amount by an additional 14.5% -- to be conservative -- for a possible national wage rate effect.**

- **In addition, SWBT did not request exogenous treatment for the growth in retiree medical claims that occurred since the beginning of price cap until when SFAS 106 was mandated. (The price cap formula, GNPPI minus productivity, had already been falling behind since 1991.)**

## Control -- January 1993 Order

- **The Commission then raised additional issues regarding whether the carriers could control the underlying costs, fundamentally changing the standard for proving lack of control.**

- **This order is on appeal at the D.C. Circuit Court. The issue on appeal is the attempt in the Jan. '93 order to re-define the burden of proof without notice or rationale.**

- **The Commissions admits that price cap LECs do not control the mandate to implement SFAS 106 on their regulated books.**

- **For a given group of employees and retirees and given benefit plans, the incremental costs of SFAS 106 are known (determined by actuarial study).**

## Further Support for Lack of Control in "TBO Filing"

- **The current filings before the Commission includes only the Transition Benefit Obligation (TBO) -- costs that have already been incurred.**

- **This further allays concerns regarding control over future retiree medical benefits. SWBT's tariff includes exogenous treatment only for the incremental costs associated with the "past portion."**

- **Thus, based on the reductions to the exogenous amounts requested by the price cap LECs, there is no double counting of SFAS 106 costs occurring from exogenous cost treatment requested and price cap formula, which includes GNP-PI .**

- **There is evidence on the record that the Union (CWA), the FASB itself and Wall Street analysts recognize that the LECs do not have practical control over the underlying benefits.**

- **Further some LECs proposed additional means of addressing concerns about control and claimed windfall profits.**

  - **Some LECs proposed monitoring of the TBO amounts and a downward adjustment to PCIs should that ever become necessary.**

  - **Some LECs have agreed to make funding a prerequisite to permanent recovery.**